

REPORT DOCUMENTATION PAGE			Form Approved OMB No. 0704-0188	
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1. REPORT DATE (DD-MM-YYYY) 28-10-2011		2. REPORT TYPE FINAL		3. DATES COVERED (From - To)
4. TITLE AND SUBTITLE Competing with the Cartels: How Mexico's Government Can Reduce Organized Crime's Economic Grip on its People		5a. CONTRACT NUMBER		
		5b. GRANT NUMBER		
		5c. PROGRAM ELEMENT NUMBER		
6. AUTHOR(S) Jason L. Morris Paper Advisor (if Any): Dr. James Butler, Ph.D.		5d. PROJECT NUMBER		
		5e. TASK NUMBER		
		5f. WORK UNIT NUMBER		
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Joint Military Operations Department Naval War College 686 Cushing Road Newport, RI 02841-1207		8. PERFORMING ORGANIZATION REPORT NUMBER		
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)		10. SPONSOR/MONITOR'S ACRONYM(S)		
		11. SPONSOR/MONITOR'S REPORT NUMBER(S)		
12. DISTRIBUTION / AVAILABILITY STATEMENT For Example: Distribution Statement A: Approved for public release; Distribution is unlimited.				
13. SUPPLEMENTARY NOTES A paper submitted to the Naval War College faculty in partial satisfaction of the requirements of the Joint Military Operations Department. The contents of this paper reflect my own personal views and are not necessarily endorsed by the NWC or the Department of the Navy.				
14. ABSTRACT Mexican drug trafficking organizations (DTOs) are now able to challenge the Mexican nation-state for dominance. Although the DTOs currently only demonstrate the desire to consolidate and expand their narcotics business, the opportunity exists for them to effectively control large areas of Mexico. And while the Mexican government is contesting the problem with the deployment of additional security forces, it has yet to make lasting progress. Today, the U.S. Government contemplates action to assist Mexico, but continues to struggle with the proper approach. An objective evaluation of the problem shows that the fundamental issues are economic; the conflict is being driven by the supply and demand of the U.S. drug market. Thus, an understanding of the Mexican economy and its socio-economic impact is critical to devising an economic means to support the conflict's resolution. This paper identifies the economic situation that exists in Mexico, explains how economic and socio-economic problems are inhibiting legal economic opportunity, and explains what economic policy and assistance options exist to address those problems. The paper challenges the notion that reinforcing Mexico's security efforts will lead to a sustainable solution. Finally the paper draws conclusions and recommends what the Mexican government should do to increase participation in the legal economy and reduce the DTOs grip on the economy.				
15. SUBJECT TERMS Mexico, Economy, Poverty Reduction, Microfinance, Regulatory Reform, Drug Trafficking Organizations				
16. SECURITY CLASSIFICATION OF:		17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES 29	19a. NAME OF RESPONSIBLE PERSON Chairman, JMO Dept
a. REPORT UNCLASSIFIED	b. ABSTRACT UNCLASSIFIED			c. THIS PAGE UNCLASSIFIED

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COMPETING WITH THE CARTELS:
HOW MEXICO'S GOVERNMENT CAN REDUCE ORGANIZED CRIME'S
ECONOMIC GRIP ON ITS PEOPLE

by

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A paper submitted to the Faculty of the Naval War College in partial satisfaction of the requirements of the Department of Joint Military Operations.

The contents of this paper reflect my own personal views and are not necessarily endorsed by the Naval War College or the Department of the Navy.

Signature: _____

28 October 2011

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Abstract

Mexican drug trafficking organizations (DTOs) are now able to challenge the Mexican nation-state for dominance. Although the DTOs currently only demonstrate the desire to consolidate and expand their narcotics business, the opportunity exists for them to effectively control large areas of Mexico. While the Mexican government is contesting the problem with the deployment of additional security forces, it has yet to make lasting progress. Today, the U.S. Government contemplates action to assist Mexico, but continues to struggle with the proper approach. An objective evaluation of the problem shows the fundamental issues are economic; the conflict is being driven by the supply and demand of the U.S. drug market. Thus, an understanding of the Mexican economy and its socio-economic impact is critical to devising an economic means to support the conflict's resolution. This paper identifies the economic situation that exists in Mexico, explains how economic and socio-economic problems are inhibiting legal economic opportunity. The paper also explains what economic policy and assistance options exist to address those problems. The paper challenges the notion that reinforcing Mexico's security efforts will lead to a sustainable solution. Finally the paper draws conclusions and recommends what the Mexican government should do to increase participation in the legal economy and reduce the DTOs grip on the economy.

INTRODUCTION

Over the last decade, a clear and present danger to the security of the United States has emerged not in the Middle East or Central Asia, but south of the border, in Mexico. Today, the seven drug trafficking organizations (DTOs, also known as drug cartels) that control the movement of illegal drugs through Mexico are contesting the Government of Mexico's (GoM's) ability to provide security in nine of the country's 31 states.¹ In 2006, in response to this growing threat, newly-elected President Felipe Calderon made good on his campaign promises to take on the DTOs and sent federal police and military units to regain control. Unfortunately, the security forces' efforts to reestablish law and order have largely failed, and the violence has skyrocketed.² Recent suggestions that negotiating with the cartels may be the only way to control the violence have lent credence to some American officials calling Mexico on the edge of being a partially "failed state."³ North of the border, the U.S. Government (USG) is weighing its options. While the Obama Administration has openly declared its support of the Calderon policies, the U.S. Department of Defense (DOD) is studying the situation in anticipation of possible future taskings to assist Mexican military and law enforcement agencies. Regardless of what is decided, future U.S. involvement in Mexico is likely to increase. America is surely going to employ all elements of its national power to prevent Mexico from losing the upper hand against the DTOs.

When the USG moves to help Mexico reestablish law and order and governance in those states where the DTOs currently dominate, there will undoubtedly be positive progress on the security situation on both sides of the U.S.-Mexican border. Unfortunately, America's insatiable demand for illegal drugs will likely just shift the problem elsewhere, just as the United States' focus on Caribbean counter-narcotics operations in the 1980s and 1990s shifted the Columbian

trafficking routes into Mexico. If there is a substantial drop in DTO operations in Mexico, the Mexican government will have to address the issue of reduced economic benefits for hundreds of thousands of people currently earning a living from the narcotics industry. For while the number of Mexicans involved in the drug trade is still on the order of tens of thousands, the fact is that in some areas of Mexico drug-related money accounts for over 20% of the local economy. This sizable portion of the local gross domestic product (GDP) “generates significant economic benefits for the population and its loss would cause substantial economic pain for the state.”⁴ For the purpose of this paper, the assumption will be made that measurable progress in the security and governance lines of effort will significantly impact the DTOs operations and lead to a significant decrease in the amount of money they inject into the local economies in Mexico. Thus, success in the ‘war on drugs’ will result in economic hardship for hundreds of thousands of Mexicans. In order to prevent long-term recidivism into the narcotics industry, the Mexican Government must provide extensive microeconomic incentives to its people in order to improve the underlying socio-economic conditions that support the drug trade and other illicit activity.

The question for policy-makers is: are there opportunities for the Mexican government to significantly reduce involvement in Mexico’s illegal economy and narcotics trafficking through policy reforms and economic assistance? This research paper will argue that the Mexican government should be encouraged to implement microeconomic incentives and reforms to encourage its people to participate in the legal economy and discourage their continued participation in either the drug trade or other illicit activity. A starting premise of this paper is that people want to earn an honest living. They just need an opportunity to do so. Understanding the underlying socio-economic conditions that have contributed to the explosion of the drug-trafficking economy in Mexico is essential for the U.S. military officer. This paper

will not address the myriad of related socio-economic issues of Mexico—education, land reform, migration, or wide-reaching corruption at all levels of government—but will focus on the economic challenges that drive people into the informal economy and the drug trade. For the DOD, this paper will hopefully deepen its institutional understanding of the economic challenges currently contributing to the instability south of the U.S.-Mexican border.

DON'T WE JUST NEED TO A BIGGER STICK?

Most Americans, especially military service members, don't want anything to do with Mexico and its problems. For many, Mexico is the source of our national illegal immigration problem, the domain of the U.S. Drug Enforcement Agency and the Border Patrol, and is not somewhere we want to send U.S. military forces. For the DOD, the challenge becomes how it can assist other USG Agencies or the GoM in dealing with what is essentially a law enforcement problem, without intruding upon Mexican sovereignty. Some experts claim Mexico is suffering from an organized crime problem that can really only be fixed through increased law enforcement and security measures.⁵ They argue that the drug problem will go away if the GoM can crush the cartels and interdict the flow of illegal drugs into America. This argument may be the most-attractive in the short-term, as the DTOs and their violence are the most obvious symptoms of the lucrative drug trade, but history has proven otherwise. Despite 30 years and tens of billions of dollars spent on the 'War on Drugs,' illegal drugs are more prevalent than ever and many experts argue that our strategy is fundamentally flawed. They counter that the U.S. has been spending too much money on the 'supply-side' of the problem and not enough on the 'demand-side.'⁶

U.S. efforts in Columbia serve as a prime example. For much of the last three decades, Columbia's near monopoly on cocaine production being shipped to the United States made it the

focus of America's counterdrug offensive. After years of dismal results, the United States initiated Plan Colombia in 2000, which focused on helping Columbia gain the initiative against the Revolutionary Armed Forces of Columbia (FARC), the armed socialist movement that had largely taken over the drug trade in Columbia. The Plan consisted of over \$7 billion dollars of aid focused on counternarcotics, military and law enforcement, and counterterrorism assistance. Less than 20 percent was designated for the socio-economic programs that provide alternative income sources for those farmers who grow the coca. While it allowed for notable gains in security and interdiction, it has largely failed to change the underlying economic conditions on the ground in Columbia. As Hal Brands writes in his 2009 SSI study:

The United States has failed to join the security and interdiction components of Plan Columbia with sufficiently bold efforts to reduce U.S. domestic demand or alter the economic calculus that drives many Columbians to participate in the drug trade. Accordingly, seized shipments are quickly replaced, coca still dominates the rural economy, and the Colombian-American drug trade continues to flourish.⁷

Poor farmers still do not have enough incentive to give them an alternative to cultivating coca, from which they can earn up to 12 times what they would with an alternative crop in the legal economy. So while Plan Colombia's short-term positive impacts have been widely publicized, its long-term viability and sustainability are questionable. When security efforts effectively neutralized FARC control in large areas of Colombia, the United Self-Defense Forces of Colombia (AUC), a demobilized paramilitary group that had allied with the Colombian government in defeating the FARC, simply assumed control of the narcotics industry. Evidence has shown the amount of narcotics smuggled into the United States has actually increased.⁸ In its simplest form drug trafficking is about supply and demand. Logically, by targeting the supply chain through increased security force capacity and pressure, governments force the distribution

network elsewhere. The results of the U.S. counternarcotic efforts in Afghanistan have been just as disappointing. So what about Mexico?

In spite of Plan Columbia's questionable results and lack of socio-economic focus, the United States went forward with the 2008 Merida Initiative to Latin America. Totalling \$1.8 billion in counternarcotics, military and law enforcement, and counterterrorism assistance to Mexico, other Caribbean nations, the Dominican Republic and Haiti, the Merida Initiative promised to improve Mexican military and law enforcement's ability to take on the DTOs. Yet, with just \$20 million dollars allocated for socio-economic programs, the Merida Plan will likely just "mow the DTO grass" and not offer any long-term reduction in the drug supply or provide sustainable socio-economic gains.⁹ The result, as events in Mexico confirm, is simply organizational adjustments within the DTOs and turf wars. As in Columbia, the Mexican cartels will undergo an adjustment period while new "narco-entrepreneurs" fight to reestablish control of their organizations. The market is then flooded with illegal narcotics to make up for interdiction losses. In the end, America's multi-billion dollar demand for drugs—an insatiable appetite—will continue to encourage people to participate in its lucrative supply.

Thus, DOD, along with its other USG partners, must directly encourage and pressure the GoM to consider the economic issues driving the Mexican drug trade, and make some fundamental changes to its economic policies. Although the reestablishment of security and law and order in Mexico is a fundamental part of the solution, unless the Mexican government provides economic incentives and alternatives to its people a holistic solution to the drug trade will remain out of reach.

MEXICO'S ECONOMY

So what is it about the Mexican economy that pushes people into the illegal economy and the arms of the DTOs? What needs to be fixed? What can the GoM do to offer economic incentives to inoculate its people against the drug money and allow them to make an honest living? To gain a greater understanding of the Mexican drug problem, the reader must first gain a basic understanding of Mexico's economy, its current challenges, and the economic impact of the drug trade. Once a basic understanding of Mexico's economy is achieved, solutions can be proposed that will assist the average Mexican in choosing the legal economy over participation in the illegal economy and DTOs.

Mexico is a “semi-industrialized, upper-middle income country with an economy that has developed and diversified significantly since the 1980s, largely on the back of an ever-expanding network of free-trade agreements and broadly orthodox fiscal and monetary policies.”¹⁰ The Mexican economy has a history of “state-managed capitalism” in which the state has played an “active and interventionist role” in key sectors of the economy, as mandated by Mexico's 1917 Constitution (see Annex A for more about Mexico's economy).¹¹ By 1982 however, the Mexican government's “statist expansion and economic populism” had over-leveraged its economy and the country was deeply in debt. When a global recession occurred, the value of the peso dropped precipitously, oil prices dropped, and interest rates rose; Mexico then defaulted on its international debt payments.¹² As a result, financial capital fled. Then the Mexican Government led by President Jose Lopez Portillo compounded the problem by nationalizing the banking industry.¹³ Ultimately, the Mexican government was forced by lenders to adopt a “neoliberal economic model” and largely remove itself from the economy. Without these economic policy changes, the GoM would never have been able to attract foreign direct

investment (FDI) or balance its books. Unfortunately, Mexico's government did not properly sequence the implementation of its policy reforms. As James Huck states in his *Global Studies Handbook*:

While the consequence of this neoliberal strategy improved macroeconomic stability in Mexico [after 1982] and restored private-sector confidence; it did so at a high social cost. Wages stagnated as prices rose, income inequality increased dramatically, and poverty and quality of life indices failed to improve.¹⁴

Following the 1982 Debt Crisis the peso was devalued in 1994, when the U.S. and International Monetary Fund took strong action to help Mexico avert another loan default. In an attempt to meet its international fiscal obligations, Mexico initiated a “wide-ranging and ambitious privatization program” in which it reduced the number of government-controlled companies from over 1,100 in 1982 to just 219 in 1994. In hindsight, the initial benefits of privatization were limited by a lack of proper oversight and poor regulatory sequencing which led to significant industry monopolization and mismanagement.¹⁵ The result was the 1995 “peso crisis,” which again significantly devalued the Mexican peso, spooked investors and resulted in USG and International Monetary Fund intervention to stabilize the Mexican economy.¹⁶ Since that time, with the enactment of the North American Free Trade Agreement (NAFTA) in 1994, the Mexican economy has continued to liberalize economically achieving a much higher level of macroeconomic stability and has transformed into an export-based economy. The result of this economic liberalization was positive but uneven economic growth. In 2009, however, the global recession hit Mexico especially hard.¹⁷ While Mexico's economy experienced stronger than expected growth in 2010, at 5.0%, the strength and duration of this recovery largely depends upon the direction of the United States' economy.

Any economic discussion on trade with Mexico must include NAFTA, which has grown the Mexican economy, but had mixed socio-economic results. Signed in January 1994, NAFTA

created the “world’s largest free trade area,” and links 441 million North Americans and \$17 trillion worth of annual trade.¹⁸ NAFTA has had positive macroeconomic effects on Mexico, but has also caused some significant socio-economic adjustments, many of which are not yet fully understood. Not only has NAFTA lowered tariffs on goods and services, but it required Mexico’s historically protectionist government to eliminate barriers and discrimination in the service sector and improve its regulatory transparency. These economic changes resulted in increased foreign direct investment (FDI), improved Mexican industrial competitiveness, and greater macroeconomic stability.¹⁹ Under NAFTA, the total quantity of goods traded between the U.S and Mexico has increased from \$293 to \$946 billion, or 223%, and the quantity of services traded has grown from \$44 to \$108 billion, or 125%. NAFTA has spurred Mexican economic development, especially in its northern region, and has encouraged “the growth of small and medium-sized businesses—the backbone of the Mexican economy.”²⁰ As the largest FDI contributor to Mexico, the United States has provided almost \$100 billion in FDI to Mexico’s economy since 1994.

Mexico must continue its reforms to reduce government bureaucratic inefficiency, corruption, and burdensome regulations to make lasting progress. Mexico has signed 12 free-trade agreements with 42 other Nations in order to reduce its dependence on American demand, but still exports over 80% of its goods and services to the United States.²¹ Such a large reliance on the U.S. economy literally means that Mexico’s future depends largely on the health of the American economy. As the saying goes, ‘if the United States catches a cold, Mexico catches pneumonia.’ It received a cruel reminder in 2009 when the global recession caused a 6.1% contraction in its real GDP while the U.S. economy declined by 2.6%.²²

NAFTA has had its fair share of critics, too. A 2005 World Bank study determined the Agreement had increased the efficiency of the Mexican economy, made it more attractive to FDI, and produced increased wages and employment in the northern Mexican States but had it not closed the income gap with the United States significantly. The study also stated that NAFTA had actually resulted in greater income disparity across Mexico.²³ While many young workers have migrated to find employment in the nearly 3,000 maquiladora manufacturing plants sprouting up in northern Mexico, there are many more that don't have access to the education or opportunity that would allow them to escape the cycle of poverty. The economic hardships faced by many Mexicans has been a direct contributor to the illegal migration of Mexican workers to America's "greener pastures" but has also lured many unemployed young men into the arms of organized crime and the illicit economy. The next section explains how the Mexican government can generate legal economic opportunities to insulate its people from the lure of the drug trade. The solution lies in the continued investment in Mexican human capital, enhancement of financial infrastructure and "microfinance", and economic policy reform.²⁴

ECONOMIC CHALLENGES AND OPPORTUNITIES

Historically poverty has been one of Mexico's most serious socio-economic problems. The U.S. State Department lists Mexico's "overall poverty rate at 44.2%, or 47 million people...with 10.5%, or 11.2 million people, [living] in extreme poverty."²⁵ Unfortunately for Mexico, in spite of economic growth and structural reforms over the last thirty years, the number of people in extreme poverty (also known as "food poverty") and moderate poverty (also called "assets-based poverty") has remained relatively constant.²⁶ Recognizing the importance of reducing poverty, the Mexican Government has made some investment in its rural poor through

its Oportunidades program with some progress being made in the areas of improved nutrition, health and education.²⁷ The GoM's "principal anti-poverty strategy...the program consisted of 46.5% of the Federal Government's anti-poverty budget and [covered] 4.2 million families...over 20% of the Mexican population" in 2003.²⁸ A November 2010 United Nations Development Program press release reported that the Oportunidades program, with assistance from the World Bank, would amount to almost \$10 billion dollars and cover 5.8 million people. Designed to improve the poor's education, health care, and nutrition the program was designed to improve the most impoverished Mexicans' chances of staying in school. Although originally focused in rural communities, Oportunidades was later expanded into the urban areas and has had a very positive impact. Unfortunately, the program is due to end at the close of 2013. This program should be expanded to help break the poverty cycle and further reduce the numbers of ordinary Mexicans who are being left behind.

Amazingly, the majority of Mexicans still do not have access to formal financial services. While Americans are accustomed to the ready access to neighborhood bank branches, direct deposit, and Automated Teller Machines (ATMs), the average Mexican does not have access to any financial institution. For example, prior to 2001, 97.5 percent of rural Mexicans had no "access to credit from a financial institution, and less than six percent used formal financial savings instruments."²⁹ In Mexico's cities the access is not much better—just 25%. The impact of this lack of access to financial services cannot be overstated. First, the lack of access drives people to the informal economy and unregulated savings and credit institutions where they can be exploited. Second, many financial studies have shown that "access to financial services hands poor people the tools to solve their own problems and to chart their own paths out of poverty."³⁰ Finally, the lack of financial services access denies potential entrepreneurs and small business

owners the capital they need to start a micro-, small- and medium-sized enterprise (mSME)³¹ and take control over their financial futures. Leveraging 21st century technology and financial systems, the Mexican government must enable each one of its citizens to have access to a bank account and basic financial education.

Recognizing the need to expand the reach of financial institutions to the poor, the Mexican Congress passed the Popular Savings and Credit Act of 2001. This Act established the National Savings and Financial Services Bank (BANSEFI), and ensured that over 400 “popular savings and credit institutions (or EACPs by their Spanish acronym) [met] new legal and regulatory standards” and had access to retail financial technology, services and electronic banking. At the same time, the Mexican government also implemented the “Rural Microfinance Technical Assistance Project (PATMIR)” within its Secretariat of Agriculture, Livestock, Rural Development, Fisheries, and Nutrition (SAGARPA) to expand the reach of the EACPs into more rural areas and “bridge the gaps in knowledge, understanding, and interaction between these financial service providers and the ...poor.”³² Since 1999, the United States Agency for International Development (USAID), the Inter-American Development Bank (IDB), and the World Bank have spent several hundred million dollars on technical assistance programs, financial systems upgrades, increased supervisory capacity, and the development of working alliances between U.S. and Mexican banks to facilitate the transfer of remittances.³³ Mexico must continue its efforts to expand financial services access to rural communities and its growing urban populations.

Countering the loss of cartel money in the economy requires increased accessibility to credit access for the Mexican entrepreneur. Studies have shown the primary drivers of modern economic development are the mSMEs. These small businesses not only employ the majority of

a nation's employable population, but also contribute significantly to its GDP. Mexico's Economic Ministry data for 2009 lists over three million licensed companies, of which over 99.5% were mSMEs that produced over 70% of its formal employment and over 50% of its GDP.³⁴ Assuming future counter-drug program success in Mexico and the reestablishment of government control, the Government of Mexico should use expanded microfinance access as a fundamental part of its post-conflict resolution strategy. Studies' dating back to 2005 show that microfinance has positively assisted in conflict recovery in Asia and the Pacific.³⁵ Microfinance should be used in Mexico to both further the expansion of financial opportunity to the poor and provide targeted incentives for Mexicans involved in cartel-related activity to cease their participation in the illegal activity. So how would this actually work?

Historically in more developed economies, start-up capital is provided by venture capital, home-equity loans, or personal savings accounts. In developing economies, where there is a historical dearth of formal financial services, there is scarce start-up capital. Whole communities or families may have to aggregate savings to start a small business. Over the last 20 years the concept of using "microfinance" to enable economic development has gathered momentum, as a means to bridge the gap between financiers and the poor. Today, microfinance across Latin America is "an expanding industry with a large growth potential"—Mexico alone had over 1.2 million borrowers in 2005.³⁶ The United States, as part of an international effort, should provide increased assistance to Mexico through USAID, the IDB, and the World Bank to expand the BANSEFI and PATMIR programs. The U.S. must also assist Mexico in the proper development and sequencing of microfinance regulatory structure to prevent a crisis similar to the one that took place in the Indian State of Andhra Pradesh in 2010.³⁷ During this crisis, unregulated micro-finance institutions (MFIs) demonstrated that they would revert to "unethical collections,

illegal operational practices (such as taking savings)...high interest rates, and profiteering” to the detriment of the most exploitable portion of the population.³⁸ Although the crisis was resolved in India, the opportunity for a Mexican crisis exists without proper industry safeguards. The point is that precedents exist for government involvement and international funding of programs to enable financial access. These programs should be expanded to reduce the average Mexican’s propensity to work in the informal economy.

Another obstacle to economic growth in Mexico is its high regulatory burden. Mexico has a program of microeconomic constraints that inhibit productivity and business growth. Clear examples of these constraints, illustrated in a 2007 World Bank Group *Doing Business* report, show that Mexican businesses face “disadvantages in (a) time and cost to open a business, (b) time and cost to obtain a license, (c) cost of hiring, and (d) cost to tax compliance.”³⁹ First, it costs more to open a business in Mexico than in China or any other Latin American country, and the costs vary by Mexican state. Second, the cost of obtaining a license to operate a business continues to be one of the highest in Latin America, although recent reforms have improved its relative standing. The impact of these excessive costs is that entrepreneurs often move into the informal economy, which accounts for about one third of Mexico’s total GDP. Unfortunately, small businesses that are not in the formal economy are even more competitively disadvantaged in a globalized economy. Third, in Mexico, it costs a company almost 24% of a worker’s annual salary to hire them, compared to just “3.3 percent in Chile, 9.75 percent in Peru, and 13.7% in Bolivia.”⁴⁰ Finally, it costs the average Mexican entrepreneur 23 days per year to pay his taxes because the tax regulations are so complicated.

While this is not an all-inclusive list, these few examples show how Mexico’s self-imposed regulatory burden creates “indirect costs that impede Mexican manufacturers in their

competition with other countries, and translate into job loss and growth reduction.”⁴¹ In the aggregate, Mexico loses 15 percent of its GDP annually because of regulatory inefficiency, according to the Mexican Institute for Competitiveness (IMCO).⁴² In summary, the Mexican government should expand some of its already existing programs and make relatively simple microeconomic policy changes in order to provide more Mexicans with the opportunity to start their own businesses in the formal economy.

CONCLUSIONS AND RECOMMENDATIONS

The security and socio-economic problems facing Mexico remain daunting. Although likely requiring U.S. assistance, any overt presence of American military forces in Mexico is a non-starter for both the U.S. or Mexican governments on the basis of national sovereignty. The United States has also learned over the last decade in Afghanistan, Columbia, and Iraq that a baseline of security enables change, but is not enough by itself to change the underlying conditions of conflict. Recent history in these three countries has shown that to achieve sustainable long-term progress governments must reinforce security gains with commensurate efforts to build good governance and expand economic development.

In the case of Mexico, the country requires a solution that addresses its unique underlying socio-economic conditions. While any strategy will require security and law enforcement capacity building, the implementation of the following recommendations will allow Mexico to provide economic incentives and alternatives to its people.

First, the Mexican government must reenact and expand its poverty reduction programs. Mexico should significantly increase its own investment into its Oportunidades program and should request matching funding by the IMF, the IDB, and the United States with the goal to continue the program for at least the next decade. This increase will responsibly continue

Mexico's investment into its human capital and also allow it to address the large numbers of internally-displaced urban migrants who are trying to escape poverty. The Mexican government should also assess its maquiladora policies and require the multi-national corporations (MNCs) currently operating there to invest in Mexico's anti-poverty programs. In the long-run, the reduction of poverty in Mexico will allow the rural and urban poor to seize the economic opportunities that will be generated by the following recommendations.

Second, the Mexican government must continue its efforts to make financial services accessible to its entire population a top priority. Fortunately, Mexico has already identified this problem and has been working on its solution for the last decade. More improvement is required. In conjunction with its expansion of the Oportunidades program, the GoM must also continue its efforts to expand BANSEFI to reach the many millions of Mexicans who still do not have access to the formal banking sector. Once the majority of Mexicans actively utilize the financial services offered by a formal bank they will be able to receive payments, invest any remittances that their family members have earned overseas, save and earn interest on the aggregated deposits, and purchase insurance policies to protect themselves from losses. As increased mutual confidence between the client and the bank grows, the availability of credit becomes more and more attractive to both lender and customer. The former sees a reliable source of future profits while the latter seizes the opportunity to build a business and improve his or her quality of life.

Third, as millions of Mexicans rise out of poverty and integrate into the formal financial sector, more and more of them will want the credit that allows them to start their own small-business and build the wealth required to rise out of poverty. To leverage the Mexican collective work ethic and desire to succeed, its government must reform its regulatory framework and

supervisory structures to responsibly manage the growing microfinance industry. Mexico must then actively support the microcredit industry by expanding transparency, access and safeguards for private microcredit providers as well as international donors and investors alike.

Finally, the recommendations made above will only come to fruition and succeed if the legacy of the state-controlled economy in its regulatory framework is reduced. The Mexican government must make it less time-consuming and less-financially burdensome to start and operate a business inside Mexico. While the transition to an export-based economy has enabled Mexico to place a foot into the globalized economy, its fundamental challenge remains how to grow the number of mSMEs operating in Mexico that will, in time, become producers and consumers in their own right. By removing its self-imposed regulatory burden, Mexico will allow businesses to operate more cheaply across the entire country while removing the drivers of internal and external migration. As one of the most competitive economies in the world, Mexico will then be able to attract both the financial and human capital it needs to build the type of diverse economy required to successfully sustain itself in the 21st century. The Mexican people will then have an alternative to the easy money of the narcotics industry.

ANNEX A: BRIEF HISTORY OF MEXICO'S ECONOMY

Mexico has been a rural and agrarian society for the majority of its existence. Ever since the arrival of the first Spaniards in the 16th century, landownership has been a source of social and legal struggle between Mexico's Spanish descendants and its indigenous peoples. In fact, one of the main causes of the 1910 Mexican Revolution was to address the "gross inequality" of one percent of the population owning almost 97 percent of the land. As described in Huck's *Mexico*, landownership has historically been a "necessary requirement to guarantee an improved quality of life...and upward social mobility."⁴³ While Mexico's modernization and urbanization has accelerated in the last few decades, its agricultural sector continues to employ millions of its citizens in both small-scale communal farms as well as large-scale commercial-style farms. One of the unfortunate side-effects of NAFTA is that the peasant farmers on the ejidos (communal farms dating back to pre-Spanish times) have been unable to compete with highly efficient American and Canadian agribusinesses. This situation, caused partially by a general lack of access to credit and modern farming resources, has forced many ejidatorios to either leave or sell their lands for opportunity elsewhere.⁴⁴ Thus, despite the doubling in agricultural trade between the U.S. and Mexico since 1994, the agricultural sector has seen many of its poorer members migrate to northern Mexico or the United States thereby become increasingly susceptible to exploitation by large-business owners or organized crime.

Mexico's energy/petroleum sector is its largest source of income and produces what is arguably its most valuable natural resource. In 2010, crude oil exports "accounted for about 6% of its GDP, 10-15% of its exports, and 30-40% of its fiscal revenues."⁴⁵ Mexico is the second largest supplier of crude oil to the United States. Unfortunately, its populist political decision in 1938 to nationalize the petroleum industry placed the entire burden of investment in

infrastructure and exploration on the Mexican government, and has made foreign oil companies averse to investing. Since the 1970s, the cumulative result has been an actual decrease in production by the state-run oil company Petroleos Mexicanos (PEMEX). The government has finally realized that it cannot rely solely on oil exports to grow the economy, but will have to diversify.⁴⁶ In an effort to reform its energy sector, President Calderon convinced the Mexican Congress to allow PEMEX to partner with private oil companies for “oil exploration and production activities, but without sharing oil or oil income.”⁴⁷ These reforms are a step in the right direction, but it appears highly unlikely that Mexico will be able to rely on increased oil income to alleviate its economic woes.

Remittances from Mexicans working overseas, primarily in the United States, have been a stable source of income for many families for decades. Recent economic data shows that remittances grew from \$8.9 to over \$25 billion between 2001 and 2008 before the U.S. recession reduced overall remittances by 16% in 2009. The importance of these remittances cannot be overstated. The poorer segment of Mexican society has come to rely on them for the majority of their food, clothing, and housing expenses. The Mexican expatriate worker living in the United States sends an average of \$1,900 a year back to their families. This is a fraction of their annual income but is “arguably a fraction of the economic contribution that person could make if they were living in Mexico...where the average worker [in 2006] made \$12,500.”⁴⁸ Studies by the World Bank and the Mexican government have estimated that U.S. remittances to the poorer southern Mexican States cover 80% of household expenses and up to 40% of the personal capital used by Mexicans to fund microenterprises in Mexico’s cities.⁴⁹

Mexico has significant industrial and manufacturing economic sectors that account for upwards of 30% of its gross domestic product. Although NAFTA has rapidly expanded

Mexico's export-related manufacturing sector, the country has been a strong exporter of "precious metals, food and beverages, clothing and textiles, and electronics" for decades.⁵⁰ Mexico remains the world's largest producer of silver and employs more than 600,000 people in its food and beverage industry. Even well before NAFTA during the late 1960s, the Border Industrialization Program (BIP) was implemented in the northern region of Mexico. The BIP created an attractive area for multinational corporate investment in which factories assemble imported components for export. These factories are known as maquiladoras or maquilas.⁵¹ Originally designed to absorb Mexican migrant guest-workers no longer able to work legally in the U.S., the maquiladora industry has grown over 40 years from several thousand employees to well over a million workers today. This has allowed multinational corporations to leverage inexpensive Mexican labor, tax and regulatory exemptions and maximize profits. While the economic benefits of the maquiladoras have led to a \$41 billion dollar economy, the tendency of these companies to hire mostly young, single women has upset traditional gender roles and contributes to the dramatic increase in violence in northern Mexico.⁵² The Mexican government's unwillingness to actively enforce labor-protections in these profitable industries has caused many workers to not trust the government or its justice system. Inadequate economic opportunities and judicial system ineffectiveness appear to have led many of Mexico's poor to turn to the cartels for income and social justice.

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NOTES

¹ Although not technically ‘cartels’ in the economic sense of price-setting, like Organization of Petroleum Exporting Countries (OPEC) does for crude oil, these DTOs have been called cartels in the press and the term is now used colloquially to describe the organized crime organizations controlling the drug trade in Mexico and the rest of Central America.

² Bob Killebrew and Matthew Irvine, “Security through Partnership: Fighting Transnational Cartels in the Western Hemisphere,” *Center for a New American Security (CNAS) Policy Brief* (Washington, D.C.: Center for a New American Security, March 21, 2011), 1.

³ Joel Kurtzman, “Mexican Instability is a Real Problem,” *The Wall Street Journal*, January 16, 2009, <http://online.wsj.com/article/SB123206674721488169.html>.

⁴ Vanda Felbab-Brown, “The Violent Drug Market in Mexico and Lessons from Columbia,” *Foreign Policy at Brookings*, Policy Paper Number 12, March 2009 (Washington, D.C.: The Brookings Institution, 2009), 14.

⁵ This claim comes from a number of sources the author used as references, and is the fundamental logic behind the Merida Initiative described in Killebrew and Irvine’s “Security through Partnership: Fighting Transnational Cartels in the Western Hemisphere,” 3.

⁶ In brief, the ‘supply-side’ of the drug problem focuses on the entire supply chain of illegal drugs, starting with the growers (who cultivate and harvest the coca, opium, or marijuana), the processors (who turn the raw product into processed drugs), and continues through the traffickers (who transport or traffic the drugs to their final destination) to the distributors who sell it to the consumer. The consumer’s use of the drug, and related second and third order effects of the abuse (crime and long-term addiction) constitute the ‘demand-side.’

⁷ Brands, “Mexico’s Narco-Insurgency and U.S. Counterdrug Policy,” 30.

⁸ Hal Brands, “Mexico’s Narco-Insurgency and U.S. Counterdrug Policy,” *Strategic Studies Institute*, May 2009,, p. 29-30.

⁹ Killebrew and Irvine, “Security through Partnership: Fighting Transnational Cartels in the Western Hemisphere,” 2.

¹⁰ Jane’s Military and Security Assessments, 1.

¹¹ James D. Huck, Jr., *Mexico: A Global Studies Handbook* (Santa Barbara: ABC-CLIO, 2009), 129.

¹² Ibid, 138.

¹³ Ibid, 156.

¹⁴ Ibid, 138.

¹⁵ Liliana Rojas-Suarez, *Growing Pains in Latin American: An Economic Framework as Applied to Brazil, Columbia, Costa Rica, Mexico, and Peru* (Washington, D.C.: Center for Global Development), 209-210.

¹⁶ Francisco Gil-Diaz, "The Origins of Mexico's 1995 Financial Crisis", *The Cato Journal*, Volume 17, Number 3, Winter 1998 (Washington, D.C.: The Cato Institute, 1998), 1, <http://www.cato.org/pubs/journal/cj17n3-14.html>.

¹⁷ M. Angeles Villareal, "U.S.-Mexico Economic Relations: Trends, Issues, and Implications," *CRS Report RL32934: Congressional Research Service*, February 24, 2011, 9.

¹⁸ U.S Department of State, "NAFTA", *U.S.-Mexico at a Glance*, United States Embassy Mexico City, May 2011, <http://mexico.usembassy.gov/>.

¹⁹ Villareal, *CRS Report RL32934: Congressional Research Service*, February 24, 2011, 6. Foreign Direct Investment (FDI) consists of foreign investments in commercial retail facilities, manufacturing plants, and real estate where the foreigner owns 10% or more of the enterprise.

²⁰ U.S. Department of State, "NAFTA," *U.S.-Mexico at a Glance*.

²¹ Organization for Economic Cooperation and Development (OECD). *OECD Economic Surveys: Mexico*, May 2011, 27-28. <http://www.oecd.org/dataoecd/59/58/47875549.pdf>.

²² Villareal, *CRS Report RL32934*, 1.

²³ Daniel Lederman, William F. Maloney, and Luis Servén, *Lessons from NAFTA for Latin America and the Caribbean*, The World Bank, 2005. Quoted in Villareal, *CRS Report RL32934: Congressional Research Service*, 18.

²⁴ Microfinance is largely understood to be the provision of financial products and services, like savings, credits, deposits, and insurance, to the poor or lower-income portion of the population. Dr. Mohammed Yunus, a young Bangladeshi economics professor, pioneered the concept of "microcredit" in 1976, when he loaned \$27 to a group of village craftsmen to start their own business. From these humble origins, Dr. Yunus founded Bangladesh's Grameen Bank, which is a "leading advocate for the world's poor that [by 2005 had] lent more than \$5.1 billion to 5.3 million people," and created a business model for hundreds of other micro-financiers around the world (from Jeffrey Gangemi, *Nobel Winner Yunus: Microcredit Missionary*).

²⁵ U.S Department of State, "Mexico: Poverty At A Glance", *U.S.-Mexico at a Glance*, United States Embassy Mexico City, January 2010, <http://mexico.usembassy.gov/>.

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- ²⁶ Liliana Rojas-Suarez, *Growing Pains in Latin American*, 199.
- ²⁷ Susan W. Parker, “Case Study: The Oportunidades program in Mexico,” Shanghai Poverty Conference – Scaling Up Poverty Reduction, April 20, 2003, 14-17.
http://www.politiquessociales.net/IMG/pdf/Mexico_oportunidades.pdf.
- ²⁸ Ibid, 5.
- ²⁹ World Bank, *Scaling Up Poverty Reduction: Case Studies in Microfinance*, Consultative Group to Assist the Poor World Bank Financial Sector Network (Washington, D.C.: World Bank, 2004), 109.
- ³⁰ World Bank, *Scaling Up Poverty Reduction: Case Studies in Microfinance*, v.
- ³¹ Although SME is common terminology in many of the development research literature I read, I have included ‘micro-‘ into the acronym to capture the smallest-end of the small-business category.
- ³² World Bank, *Scaling Up Poverty Reduction: Case Studies in Microfinance*, 108-109.
- ³³ Ibid, 122.
- ³⁴ Referenced from the Mexican Ministry of Economy website (www.economia.gob.mx) by Juan Ramos Diaz, *Microfinance Regulation in Mexico: Lessons and Challenges Ahead*, Commission Nacional Bancaria y de Valores, March 2010, 3.
- ³⁵ Pascal Marino, “Beyond Economic Benefits: The Contribution of Microfinance to post-conflict recovery in Asia and the Pacific,” *The Foundation for Development Cooperation*, April 2005, 1.
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- ³⁷ CGAP, “Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance.” CGAP Focus Note 67 (Washington, D.C.: CGAP, November 2010), 5-6.
- ³⁸ Ibid, 3-4.
- ³⁹ Haar and Price, *Can Latin America Compete? Confronting the Challenges of Globalization*, 258-261.
- ⁴⁰ Ibid, 260.
- ⁴¹ Ibid, 261.
- ⁴² Ibid, 254.

⁴³ Huck, *Mexico: A Global Studies Handbook*, 142.

⁴⁴ Ibid, 144.

⁴⁵ U.S Department of State, “Macroeconomic Snapshot,” *Snapshot U.S.-Mexico*, United States Embassy Mexico City, May 2011, <http://mexico.usembassy.gov/>

⁴⁶ Huck, *Mexico: A Global Studies Handbook*, 149.

⁴⁷ U.S. Department of State, “Macroeconomic Snapshot.”

⁴⁸ Jerry Haar and John Price, *Can Latin America Compete? Confronting the Challenges of Globalization* (New York: Palgrave MacMillan, 2008), 6.

⁴⁹ Federal Reserve Bank of Dallas, “Workers’ Remittances to Mexico,” 2004, and several World Bank and Mexican Government Reports referenced in Villareal, *CRS Report RL32934*, 10.

⁵⁰ Huck, 149.

⁵¹ Ibid, 151.

⁵² Ibid, 152.